SUMMARY

The position of the financial sector strengthened last year, aided by the growth of the domestic economy. The environment of strong growth, which is favourable for both corporate and household balance sheets, can be expected to persist in the coming quarters. Both the real economy and the financial sector are becoming increasingly interconnected with the external environment. This is generating many positive factors, but also certain risks. The domestic financial market is greatly affected by developments on global and regional markets. The economy is profiting from foreign investors' interest. Restructuring of the corporate and financial sectors has led to greater efficiency and is generating better economic performance and a lower external imbalance. On the other hand, substantial amounts of earnings are being repatriated abroad, thus contributing to the current account deficit. The activities of foreign businesses are increasing the competition among financial services providers yet are creating challenges for effective supervision of the financial sector. Financial stability is, of course, also affected by domestic developments. The acceleration in lending in a phase of economic recovery may lead to higher future risks, which could materialise particularly in the event of an economic downturn. When making their decisions, financial institutions should take due account of such factors.

Global economic growth continued, despite the high oil prices

The world economy continued growing in 2005. The rate of recovery in the major economic regions (the USA and the EU) slowed slightly. Although prices in real terms were close to the levels in the period of the second oil shock, the major world economies showed great resilience to such developments. The Central European economies continued to grow much faster than Western European countries.

From the financial stability point of view, the outlook for the external environment remains favourable …

The growth of the US economy is expected to slacken slightly in response to a downswing in household consumption, but growth in Germany and the euro area as a whole is expected to record a modest pick-up, driven by investment and industrial activity. This should create favourable conditions for Czech exports and economic growth.

…but there are, of course, some risks as well

The world economy is exposed to some factors which may affect medium-term economic growth and the stability of international financial markets. One of these issues is the widening of the current account deficit in the USA, driven by household and general government indebtedness. The deficit has so far been financed by inflows of foreign capital. Moreover, the gradual tightening of US monetary policy may depress the rate of growth of household debt and help reduce the current account deficit. A marked dollar depreciation may affect international capital flows and economic growth. A sizeable increase in yields in advanced economies could worsen market sentiment regarding developing economies and cause an outflow of capital from these regions. Also a further potential rise in oil prices could threaten global economic growth. Some of these risks motivated the preparation of the alternative macroeconomic scenarios used in the stress tests.

Domestic macroeconomic developments in 2005 were favourable

In 2005, economic growth in the Czech Republic picked up quite sharply and inflation remained low. A trade surplus considerably reduced the current account deficit. The favourable trend on the supply side of the economy continued, reflected in higher growth in the non-accelerating inflation rate of output. Despite remaining a challenge in the longer term, public finances recorded a lower-than-planned deficit in 2005, thanks mainly to the higher-than-expected economic growth.

The baseline macroeconomic forecast suggests no risks to financial stability…

The CNB's macroeconomic forecast of April 2006 expects the economy to fluctuate around a zero output gap and foresees a modest pick-up in inflation associated with changes to regulated prices and indirect taxes. Consistent with the forecast is interest rate stability initially and a gradual rise in rates thereafter. The baseline scenario does not pose any immediate risks with regard to financial stability.

…but less favourable macroeconomic scenarios are also analysed

The Report analyses three alternative economic scenarios describing potential adverse developments in the external and domestic economic environments. At first we analyse a scenario which assumes a pronounced rise in interest on the major world currencies, resulting in weaker global economic growth and a decline in demand for Czech exports. We also examine a scenario that assumes an appreciation of the koruna combined with a supply shock leading to higher inflation. The final scenario involves a decline in domestic demand. The scenarios model the impact of these developments on the domestic economic environment and on the quality of the loan portfolio. This is followed by an analysis of the effect of these macroeconomic scenarios on the banking sector's stability using stress tests.

The domestic financial market is highly interconnected with international financial markets

Global financial markets reflected the monetary policy tightenings in the USA and partly also in the euro area. Long-term yields on ten-year government bonds in the USA and the euro area, however, did not follow the rise in short-term rates and the yield curves thus flattened. In 2005, Czech nominal ten-year government bond yields reached their lowest level since 2001. Share prices continued rising, pushed up chiefly by demand from foreign investors. Prices of financial assets on Czech markets depend to a large extent on global sentiment or move in line with developments in other Central European economies. The high correlation of movements in the exchange rates of the koruna and other Central European currencies against the euro has declined in recent quarters. The widening negative interest rate differential of the koruna vis-à-vis the euro is stimulating the use of the Czech koruna as a cheap financing currency for investment in other currencies. Any turbulence on global or regional markets poses a potential risk to the Czech financial market and financial stability.

The corporate sector's results remain very good

The economic growth had a positive effect on the turnover ratios of the corporate sector. However, the profitability of large firms was slightly lower than in the extraordinarily successful year 2004. The financial indicators of the corporate sector are to some extent sensitive to oil price movements and the speed of appreciation of the exchange rate. Adverse changes in these factors can affect the quality of loans to corporations. The increasing concentration of production into some industries may increase the sensitivity of economic results to any problems in individual large firms. The rise in lending to the corporate sector in 2005 was driven by SMEs, while the debt of large enterprises decreased. The increasing availability of funds for SMEs is a positive phenomenon. On the other hand, these loans are associated with higher credit risk. The Report presents model estimates of the credit risk of bank loans in response to the evolution of key macroeconomic indicators.

Household debt continued growing

The low interest rates, economic growth, higher employment and rising disposable incomes created favourable conditions for household indebtedness. The rise in households' debt is, however, still lower than the growth in their financial assets. Despite the low interest rates, the rising household debt is starting to feed through to an increasing share of interest expenses in their disposable income. In recent years, household disposable income growth has been relatively slow. Some households may thus have problems repaying their loans.

The debt is concentrated primarily in high-income groups of households

A new analysis of the family budget statistics suggests that in past years the debt has been concentrated predominantly in high-income households. Nonetheless, the indebtedness of low-income households is starting to rise as well. Relatively high loan repayments are negatively affecting the ability of some households to finance other expenditure and generate new savings. Credit risk may also be increased in these households by the higher dependence of their disposable incomes on social transfers. The number of executions – a fast and relatively efficient way of enforcing smaller household debts – continues rising. The possibilities for debt enforcement will improve thanks to changes in insolvency law, which are discussed in a thematic article. This underlines the need for a prudential approach by both households and banks to the issue of borrowing and related risk management.

The significance of the real estate market is increasing as mortgages continue rising

Mortgages account for two-thirds of loans to households. The available data suggest a stagnation or only modest rise in prices of various types of real estate since 2003. This may be connected with the increasing supply of new housing construction. Against this background, real estate prices are showing a gradual regional convergence. An analysis of the implicit return on rent does not signal the existence of a bubble on the real estate market. The situation on the real estate market is complicated by the persisting price differences between regulated and market rents.

The banking sector increased its lending to the private sector

The growth in loans provided by banks to the private sector picked up in 2005 in line with the favourable developments in the macroeconomic environment. The growth was driven mainly by loans to households, but loans to corporations went up as well. The trend of improving loan quality continued. The share of non-performing loans in total non-bank client credit stood at 4.1% at the end of 2005. The Report analyses the banking sector's sensitivity to various risks (credit risk, interest rate risk, foreign exchange risk and interbank contagion risk). Banks are also exposed to other risks – for instance operational risk. Given the share of loans in the asset structure, credit risk is the most significant risk for the banking sector.

The banking sector remains profitable

The banking sector was highly profitable for the fourth year in a row in 2005. Banks created a net profit of CZK 39.4 billion, a year-on-year increase of 20%. Profit creation is an important factor affecting the financial stability of the system, since it allows the formation of a cushion for risk coverage. However, sufficient profit must be kept in bank's balance sheets. Almost 60% of the net profit created in 2004 remained in banks' balance sheets. Dividends paid totalled CZK 13.6 billion, i.e. 41.5% of the net profit of the banking sector. The decision on the method for the distribution of profit for 2005 has not yet been made. Owing to the prevailing foreign ownership, most of the dividends were transferred abroad. This contributed to the current account deficit. The profitable banking sector suggests improved efficiency and cost management. In the thematic article part of the Report we analyse whether and to what extent the cost efficiency of banks can be used as an early warning signal of bank problems.

The capital adequacy of banks fell slightly

Capital adequacy fell slightly from 12.6% to 11.9%, mainly because of higher capital requirements resulting from the dynamic growth in lending. A model analysis examined banks' sensitivity to credit, exchange rate and interest rate risks. The stress tests were, moreover, extended to include an analysis of interbank contagion risk and an analysis of the impacts of alternative macroeconomic scenarios using a macroeconomic credit risk model. The banking sector as a whole fared well in these tests, with a capital ratio of above 8%. As the new capital accord (Basel II) will probably lead to a decline in the overall capital adequacy of banks in the Czech Republic, sufficient capital formation is becoming a new challenge for banks in the conditions of rapidly growing lending.

The structure of the financial sector remains virtually unchanged

The development of non-banking financial institutions, reflecting above all households' efforts to diversify their assets, continued. However, the banking sector maintained its dominant position in 2005, holding about three-quarters of the total assets of the financial sector. The proportion of banks in the financial sector is approaching the euro area average. The depth of financial intermediation (as measured by the ratio of financial sector assets to GDP) is lower in the Czech

Republic than in the euro area. In the context of the Central European region, however, the ratio for the Czech Republic is high. The range of services offered by insurance companies, pension funds, domestic and foreign collective investment funds and other non-banking financial institutions is gradually expanding. Insurance companies met the solvency criteria and, like pension funds, are compliant with the limits of safe asset allocation. Investment firms also met the capital adequacy criterion.

The internationalisation of the financial sector poses a challenge for cross-border supervisory co-operation

Financial services providers form and operate consolidated groups headed by large banks and insurance companies. The ownership structures of domestic financial institutions are strongly linked with partners from other EU countries. Foreign ownership is having positive effects in terms of higher profitability, better risk management and a wider range of products, services and distribution channels. This is yielding substantial benefits for customers in the Czech Republic. At the same time, foreign ownership is also bringing new potential risks. In particular, it can create new channels of transmission of foreign shocks. The closer integration of the Czech financial sector into the international environment is also associated with the process of creation of the single European financial services market. A number of financial entities are operating under the single European licence system. Hundreds of other banks, insurance companies and investment firms have made notifications and can offer their services in the Czech Republic under the principle of free cross-border provision of services. Banks from outside Europe are also considering establishing branches in the Czech Republic. The growing internationalisation of the financial market is therefore increasing the significance of co-operation with the home supervisors of foreign financial institutions.

Financial stability was supported by smooth functioning payment and settlement systems

A prerequisite for effective and smooth functioning of the entire financial sector is the existence of sound payment and settlement systems. For this reason, supervision of the interbank payment system CERTIS and the short-term bond system SKD is one of the main tasks of the CNB. Both systems are operated by the CNB and process transactions worth hundreds of billions of korunas each day. The CERTIS in particular is recording a rising number and volume of transactions without any threat to the smooth functioning of the system. A major change to the SKD system was the creation of the function of custodian. Custodians maintain customer accounts within the legally permitted two-tier registration of securities.

PART I